Internal Revenue Service
memorandum

CC:FS:TL-N-1467-92
CORP:LEGardner

date: DEC 2 1991

to: District Counsel, Nashville CC:NAS
Attn: Vallie Brooks

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This is a written response to your request for Field Service Advice.

ISSUES

(1) Whether a distribution to shareholders coupled with a reduction in proportionate interest of the shareholders interest in [redacted] can be treated as a redemption.

(2) Whether the transaction described below can be treated as a recapitalization.

CONCLUSIONS

We conclude that the transaction described below cannot be treated as a redemption or a recapitalization for the reasons listed below. Our conclusions are based upon the facts described below as presented by the Revenue Agent.

FACTS

During the fall of [redacted], the management of [redacted] (hereinafter [redacted]), members of the Board of Directors, and their respective legal and financial advisors considered various plans to meet the following goals: (1) to provide stockholders with the opportunity to realize a significant portion of the value of their shares in cash, while retaining approximately [redacted] percent of their current equity interest in the company, and (2) to provide increased employment and performance incentives to officers and key employees of the company through increased equity participation. On [redacted], the Board of Directors of [redacted] (hereinafter [redacted]) approved a plan, styled "Plan of Recapitalization" (hereinafter the Plan). The Plan was approved by the stockholders on [redacted].

The Plan encompassed the declaration and payment of a cash dividend to shareholders in the amount of $[redacted] per share and the granting of [redacted] additional shares of "restricted stock"

09595

to certain officers and key employees of the company. This additional "restricted stock" constituted about [redacted] percent of the company's total outstanding common shares on a fully diluted basis after giving effect to the "recapitalization." The shares of "restricted stock" would vest in equal installments over [redacted] years partially on the basis of performance and partially on the basis of continued employment with the company. After giving effect to the "recapitalization," management would hold restricted shares representing approximately [redacted] percent of the company's outstanding shares on a fully diluted basis.

During [redacted], pursuant to the Plan, [redacted] distributed to its shareholders a cash dividend of $[redacted] per share, aggregating $[redacted]. As a result of these transactions, the proportionate interests of the shareholders other than the officers and employees were reduced. In order to pay the dividend and the fees and expenses incurred in connection with the "recapitalization," approximately $[redacted] in newly issued debt was required. [redacted] claimed a deduction of $[redacted] for outside expenses (professional fees and printing costs) incurred in connection with the "recapitalization," on its tax return for the taxable year ended [redacted].

The Revenue Agent has proposed an audit adjustment that would reclassify the above-mentioned expenses as non-deductible capital expenditures. In support of the proposed adjustment, the Revenue Agent asserts the following: (1) The Plan qualifies as a "reorganization" under section 368(a)(1)(E) and, therefore, such related expenses should be capitalized; (2) the Plan was a "de facto" redemption of [redacted] percent of [redacted] shares and, therefore, expenses related thereto should be capitalized under (former) section 162(l), now section 162(k); and (3) the Plan resulted in a change in corporate structure for the benefit of future operations, and "asset" for which costs should be capitalized under the rationale of National Starch and Chemical Corporation v. Commissioner, 93 T.C. 67 (1989). We note that the Revenue Agent requested that we advice him on the first two issues. The third issue, which is discussed in the taxpayer's protest letter, apparently is another issue the Revenue Agent proposes to base the adjustments on. However, since the Revenue Agent has not requested our advice on this issue, we will not consider it. Should your office determine that you would like our office to respond to this issue, please let us know.

DISCUSSION

THE REDEMPTION ISSUE

Amounts paid or incurred by a corporation in connection with the redemption of its stock after February 28, 1986, in taxable years ending after that date, must be capitalized. Section 162(k) (formerly section 162(l)); see S. Rept. No. 99-313, 1986-

3 C.B. (Vol. 3) 222-223; Conf. Rept. No. 99-841, 1986-3 C.B. (Vol. 4) 168-169.

Section 302(a) provides that if a corporation redeems its stock (within the meaning of section 317(b)), and if paragraphs (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

Section 317(b) provides that for purposes of this part, stock will be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Under section 317(b), stock is treated as redeemed by a corporation if the corporation acquires its stock in exchange for property. In this case, [redacted] received none of its own stock in exchange for the cash distribution. Since the exchange requirement of section 317(b) has not been met, the distribution should not be treated as a redemption.

Even though the exchange requirement of section 317(b) has not been met, the question is whether the dividend, when coupled with a decrease in the proportionate interest of the shareholders receiving the dividend, may be treated as a redemption. We have found no authority for treating a dividend distribution coupled with a decrease in proportionate interest as a redemption.

The Tax Court has held that a distribution that is in substance and form a dividend will not be recharacterized as a redemption. Reitz v. Commissioner, 61 T.C. 443 (1974). In Reitz, the taxpayers owned stock in a hospital corporation. On November 30, 1968, the corporation declared a dividend of all cash on hand and receivables to its shareholders. On December 1, 1968, the shareholders donated their shares to the local government. The taxpayers argued that the November 30 distribution was not in substance a dividend, but rather it was a redemption of a portion of their stock and a gift of the remaining shares to the local government. The court held that the form of the transaction, a dividend and a gift, was its substance, and that the transaction could not be considered a redemption because the corporation did not redeem petitioner's stock, and the record did not show that any party to the transaction ever contemplated a redemption.

Furthermore, if the Service were to treat this distribution as a redemption, other taxpayers who receive a cash dividend but exchange no stock could argue that the dividend should be treated as a redemption under section 302. This could result in the dividend being treated under section 302 as a distribution in part or full payment in exchange for stock even though the shareholders exchanged no stock. Compare Treas. Reg. § 1.311-2(a)(2), which requires an actual redemption for purposes of applying the pre-1984 version of section 311(d) even though the economics of the transaction would have been the same regardless whether stock was given up or not.

For the reasons stated above, [redacted]'s cash distribution to its shareholders cannot be treated as a redemption.

THE RECAPITALIZATION ISSUE

Amounts paid or incurred in connection with a recapitalization of a corporation are nondeductible, capital expenditures. Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268 (2d Cir. 1941); Motion Picture Capital Corp. v. Commissioner, 80 F.2d 872 (2d Cir. 1936).

The requirements of a recapitalization under section 368(a)(1)(E) are that: (1) It must be a "readjustment of the capital of a single corporation" (Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202 (1942); (2) there must be an exchange of capital interests; (3) there must be a bona fide business purpose; and (4) the exchange must be an isolated transaction and not part of a plan to periodically increase a shareholder's proportionate interest in the corporation (G.C.M. 39088, [redacted], (Dec. 7, 1983).

In this case, [redacted]'s shareholders received a cash distribution. They did not exchange or receive any interest in the corporation. Thus, the exchange requirement has not been met, and the transaction cannot be treated as a recapitalization.

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If you have any questions regarding this matter, please contact Lorraine E. Gardner at (FTS) 566-3335.

DANIEL J. WILES

Alfred C. Bishop, Jr.

ALFRED C. BISHOP, JR.
Chief, Corporate Branch
Field Service Division